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IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA

The Defendants in this matter have each filed Motions to Dismiss (Doc. 80–81). For the reasons set forth below, however, both Motions are denied.¹

BACKGROUND

This action arises as a result of a September 24, 2008 Restatement issued by Medicis Pharmaceutical Corporation (“Medicis” or the “Company”). In that Restatement, the Company revised its 2003–2008 financial statements due to a violation of Generally Accepted Accounting Principles (“GAAP”). Specifically, Medicis and its independent auditor, Ernst & Young LLP (“Ernst & Young”), announced that the Company’s prior financial statements were incorrect due to a misinterpretation of Statement of Financial Accounting Standards No. 48, *Revenue Recognition When a Right of Return Exists* (“SFAS 48”).

¹The parties' requests for oral argument are denied as the Court has determined that oral argument will not aid in its decision. *See Lake at Las Vegas Investors Group v. Pac. Malibu Dev.*, 933 F.2d 724, 729 (9th Cir. 1991).

1 Under SFAS 48, a seller who offers products for sale with a right of return may
2 recognize revenue on a sale only if certain conditions are met. (*See Doc. 57, Ex. D at ¶ 6*).
3 For example, the seller must be able to reasonably estimate the number of likely returns and
4 must exclude the value of those returns from its total revenue. *See id.* SFAS 48 further
5 requires the seller to establish and maintain a reserve based on the *full sales price* of each
6 anticipated return. *See id.* SFAS 48, however, is not without exception. Under Footnote 3 to
7 that provision, a seller *may* recognize revenue on certain products sold with a right of
8 exchange. *See id.* at 10 n. 3. Pursuant to Footnote 3, “Exchanges by ultimate customers of
9 one item for another of the same kind, quality, and price (for example, one color or size for
10 another) are not considered returns for purposes of this Statement.” *Id.* Otherwise, SFAS 48
11 explicitly provides that “exchanges for other products” are to be treated as returns. *Id.* at ¶
12 3. Thus, exchanges that are not the same in “kind, quality and price” must be accounted for
13 by reserving the full sales price for these exchanges. *See id.*

14 The GAAP violation at issue in this case pertains to the way Medicis and Ernst &
15 Young (collectively “Defendants”) recognized revenue for pharmaceutical products sold with
16 a right of exchange. As part of the Company’s regular business practice, Medicis sold its
17 products to wholesale distributors. But, while these sales were final and non-refundable,
18 Medicis allowed distributors to exchange pharmaceuticals, as they neared expiration, for
19 fresher products. To recognize revenue on the sale of these pharmaceuticals, Medicis was
20 required to estimate the number of likely exchanges and reserve the value of those exchanges
21 from the Company’s total revenues. Medicis established the requisite reserve, but in doing
22 so, the Company did not reserve the *full sales price* for estimated exchanges. Instead, relying
23 on Footnote 3’s exception to SFAS 48’s general provisions, Defendants reduced Medicis’s
24 sales revenue by the *cost of replacing* short-dated or expired drugs with fresher
25 pharmaceuticals. (*See Doc. 57, Ex. D at ¶ 6*).

26 Defendants’ interpretation of Footnote 3, however, was misplaced. In 2008, the Public
27 Company Accounting Oversight Board questioned Defendants’ methodology, noting that
28 expired drugs cannot be considered to be the same in “kind, quality, and price” as fresh

1 pharmaceuticals. Hence, though replacement cost accounted for the actual economic impact
2 of the exchanges, the audit indicated that Defendants should have set reserves based on the
3 full sales price of these products under SFAS 48.

4 The revelation of Defendants' violation of SFAS 48 required Medicis to issue the
5 September 2008 Restatement. The Restatement demonstrates that Medicis's violation of
6 GAAP primarily had an effect on the timing of the Company's revenue recognition. In 2003,
7 for instance, Medicis overstated revenues by \$37.2 million, while in 2006, revenues were
8 understated by \$44 million. (*See Doc. 59, Ex. B at 3*). The following table reflects the impact
9 of the revised reserve calculations on Medicis's financial statements from 2003–2008:

<i>Net Revenue (in millions)</i>	Fiscal year Ended 12/31/07	Fiscal year Ended 12/31/06	Transition Period Ended 12/31/05	Fiscal year Ended 06/30/05	Fiscal year Ended 06/30/04	Fiscal year Ended 06/30/03
As Reported	\$ 464.7	\$ 349.2	\$ 164.0	\$ 376.9	\$ 303.7	\$ 247.5
Adjustment	- 7.3	+ 44.0	+ 1.3	- 11.2	+ 11.5	- 37.2
As Restated	\$ 457.4	\$ 393.2	\$ 165.3	\$ 365.7	\$ 315.2	\$ 210.3

15 As these numbers demonstrate, Medicis overstated revenues during some of the restated
16 fiscal periods and understated revenues in others. In the aggregate, the accounting violation
17 resulted in an understatement of net revenues of approximately \$1.1 million over the entire
18 six-year period. But while total revenues did not substantially change, the revelation of the
19 accounting violation allegedly caused a substantial drop in Medicis's stock price.
20

21 Following the drop in Medicis's stock value, Plaintiffs filed the instant action alleging
22 that Defendants violated § 10(b) of the Securities and Exchange Act of 1934 because
23 Medicis's original financial statements were false or misleading due to the Company's
24 violation of GAAP. According to Plaintiffs, Defendants intentionally, or with deliberate
25 recklessness, manipulated revenues by ignoring SFAS 48. Plaintiffs further allege that
26 several of Medicis's corporate executives contributed to the false or misleading statements
27 and are therefore liable under § 10(b) or § 20(b) of the Exchange Act. These executives
28 include: CEO Johan Shacknai; CFO Richard D. Peterson; and COO Mark A. Prygocki.

1 This is the second time that Defendants have moved to dismiss this action. In
2 December 2009, the Court dismissed Plaintiffs' First Amended Complaint with leave to
3 amend because Plaintiffs failed to raise a strong inference of scienter as to any of the
4 Defendants. *See In re Medicis Pharm. Corp. Sec. Litig.*, 689 F. Supp.2d 1192 (D. Ariz.
5 2009). The Second Amended Complaint pleads much more particular allegations and
6 attempts to cure these defects by (1) presenting opinion testimony from an accounting expert²
7 regarding Defendants' state of mind; (2) providing excerpts from Medicis's public
8 filings—which allegedly suggest that Medicis disguised the manner in which the Company
9 was accounting for exchanges; and (3) presenting allegations that suggest that Defendants
10 intentionally exploited their improper accounting methodology to create a false impression
11 of consistent company growth. (*See Doc. 76*).

LEGAL STANDARD

To establish a valid claim pursuant to § 10(b) and Rule 10b-5 promulgated thereto, a plaintiff must satisfy five elements: “(1) a material misrepresentation or omission of fact, (2) scienter, (3) a connection with the purchase or sale of a security, (4) transaction and loss causation, and (5) economic loss.” *In re Daou Sys. Inc., Sec. Litig.*, 411 F.3d 1006, 1014 (9th Cir. 2005) (citing *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005)).

To state a claim pursuant to § 10(b), federal securities complaints must satisfy stringent pleading requirements. Of particular relevance in the instant case, the Private Securities Litigation Reform Act (“PSLRA”) requires a complaint to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind,” or scienter. 15 U.S.C. § 78u-4(b)(2); *see Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976). The required state of mind is either that the defendant acted intentionally or with “deliberate recklessness.” *Daou Sys.*, 411 F.3d at 1014–15. Because the misconduct must be

26 ²The parties debate whether expert opinion can be used to support Plaintiffs'
27 allegations of scienter. This dispute, however, need not be resolved at this time because
28 Plaintiffs' allegations give rise to a cogent inference of scienter regardless of whether the
statements from this expert are considered.

1 “deliberate,” recklessness does not satisfy the PSLRA’s pleading requirements unless it
2 “reflects some degree of intentional or conscious misconduct.” *In re Silicon Graphics Sec.*
3 *Litig.*, 183 F.3d 970, 977 (9th Cir. 1999); *see also DSAM Global Value Fund v. Altris*
4 *Software, Inc.*, 288 F.3d 385, 389 (9th Cir. 2002) (holding that in order to allege a strong
5 inference of deliberate recklessness, a plaintiff must state “facts that come closer to
6 demonstrating intent, as opposed to mere motive and opportunity”) (citations omitted). In
7 short, to plead scienter, a plaintiff must plead “no less than a degree of recklessness that
8 strongly suggests actual intent” by providing “in great detail, facts that constitute strong
9 circumstantial evidence of deliberate recklessness or conscious misconduct. *Silcon Graphics*,
10 183 F.3d at 973, 979.

11 To survive a motion to dismiss, the inference of scienter must be “cogent and at least
12 as compelling as any opposing inference one could draw from the facts alleged.” *Tellabs, Inc.*
13 *v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 324 (2007). The inference of scienter,
14 however, “need not be irrefutable, *i.e.*, of the ‘smoking gun’ genre or even the ‘most
15 plausible of competing inferences.’” *Id.* (citations omitted). In determining the cogency of
16 the allegations at the motion to dismiss stage, federal courts are required to consider whether
17 “all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not
18 whether any individual allegation, scrutinized in isolation, meets that standard.” *Id.* In other
19 words, courts may not rely “exclusively on a segmented analysis of scienter.” *Zucco Partners*
20 *v. Digimarc Corp.*, 552 F.3d 981, 991 (9th Cir. 2009). Instead, courts must “consider the
21 totality of the circumstances[.]” *Id.* at 992 (citing *South Ferry LP, No. 2 v. Killinger*, 542
22 F.3d 776, 784 (9th Cir. 2008)). Thus, in addressing the question of scienter, federal district
23 courts must “conduct a dual inquiry.” *Id.* First, courts must “determine whether any of the
24 plaintiff’s allegations, standing alone, are sufficient to create a strong inference of scienter;
25 second, if no individual allegations are sufficient,” courts must then “conduct a ‘holistic’
26 review of the same allegations to determine whether the insufficient allegations combine to
27 create a strong inference of intentional conduct or deliberate recklessness.” *Id.*

28

DISCUSSION

1 Applying the PSLRA’s pleading standard to the facts of this case, the primary issue
2 is whether the Second Amended Complaint, read most favorably to the Plaintiffs, but
3 considering all reasonable inferences, alleges particular facts giving rise to a strong inference
4 that the Defendants made fraudulent representations or omissions, either with knowledge of
5 their falsity or with deliberate recklessness. Though it is a close case, Plaintiffs have
6 adequately pled facts demonstrating the requisite degree of scienter to support their §§ 10(b)
7 and 20(a) claims.³

8 **I. Plaintiffs Have Alleged a Cogent Inference of Deliberate Misconduct Under §
9 10(b).**

10 Because GAAP requires companies to exercise a measure of judgment when they
11 make accounting decisions, a plaintiff cannot demonstrate scienter simply by pointing to an
12 accounting error and pleading facts that show a defendant was aware of the accounting
13 methods that ultimately turned out to be in violation of GAAP. *See DSAM Global Value
Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002) (“[M]ere allegations that an
14 accountant negligently failed to closely review files or follow GAAP cannot raise a strong
15 inference of scienter.”). Otherwise, almost all accounting errors and GAAP violations would
16 give rise to scienter. Hence, allegations of GAAP violations generally are insufficient to
17 establish scienter unless those allegations are pled “in conjunction with other details
18 establishing that a defendant” acted with the requisite state of mind. *See In re Ramp
19 Networks, Inc. Sec. Litig.*, 201 F. Supp.2d 1051, 1074 (N.D. Cal. 2002) (citing *In re Nuko
20 Sec. Litig.*, 199 F.R.D. 338, 344 (N.D. Cal. 2000)). As other courts have observed, such
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22 ³The parties have requested consideration of several documents related to the pending
23 claims including SFAS 48 and various SEC filings. None of the parties dispute the
24 authenticity of these documents, and they do not object to their consideration. Thus, to the
25 extent that the relevant documents are incorporated by reference or are subject to judicial
26 notice, the Court has considered them as appropriate in resolving the pending motions.
27 *Marder v. Lopez*, 450 F.3d 445, 448 (9th Cir. 2006) (discussing the parameters of the
incorporation by reference doctrine); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th
Cir. 1991) (allowing consideration of items that are properly the subject of judicial notice on
a motion to dismiss).

1 detailed allegations might include: (1) the magnitude, obviousness, and reasonableness of the
2 violation; (2) the omission in public statements of material facts related to the GAAP
3 violation; (3) the defendant's potential motive or reason for using the accounting methods
4 it did; and (4) other statements or conduct indicating that the defendant intentionally or
5 recklessly misapplied GAAP. *PR Diamonds, Inc. v. Chandler*, 364 F.3d 671, 684 (6th Cir.
6 2004) (holding that an inference of scienter "may be drawn from allegations of accounting
7 violations that are so simple, basic, and pervasive in nature, and *so great in magnitude*, that
8 they should have been obvious to a defendant"); *In re Focus Enhancements, Inc. Sec. Litig.*,
9 309 F. Supp.2d 134, 152 (D. Mass. 2001) (holding that the omission of the relevant
10 accounting treatment from public disclosures may give rise to an inference of scienter);
11 *Hypercom Corp. Sec. Litig.*, 2006 WL 726791, at *9 (D. Ariz. Jan. 25, 2006) (observing that
12 [t]he presence of 'motive' . . . may contribute to a strong inference of scienter") (citation
13 omitted); *Zucco Partners*, 552 F.3d at 995 (noting that specific and detailed allegations from
14 confidential witnesses can be used to demonstrate that a statement was made recklessly or
15 with deliberate indifference).

16 In their Second Amended Complaint, Plaintiffs primarily raise three bases for scienter:
17 (1) the violation of GAAP was so simple and obvious that Defendants must have known of
18 the error (2) Medicis's public disclosures demonstrate that Defendants were concealing the
19 Company's "tenuous" accounting methodology from investors; (3) Defendants exploited its
20 accounting methodology to manipulate the timing of revenue recognition and to create a false
21 impression of Company growth. Considering these allegations in aggregate, Plaintiffs have
22 alleged facts giving rise to a cogent inference of scienter.

23 **A. The Simplicity or Obviousness of Defendants' Accounting Mistake Gives
24 Rise to At Least Some Inference of Scienter.**

25 Accounting errors that prove to have a significant impact on core business
26 operations—i.e. cash, revenue, profits, liquidity, or viability of a product, sometimes give rise
27 to a compelling inference of scienter. See *PR Diamonds*, 364 F.3d at 684. This is so because
28 such substantial errors give rise to an inference that the defendant acted recklessly or

1 intentionally used deceptive accounting principles to disguise serious problems. In *PR*
2 *Diamonds*, for instance, the Sixth Circuit held that an inference of scienter “may be drawn
3 from allegations of accounting violations that are so simple, basic, and pervasive in nature,
4 and *so great in magnitude*, that they should have been obvious to a defendant.” *Id.*; *see also*
5 *In re Acosta*, 406 F.3d 367, 372 (5th Cir. 2005) (holding that the “sheer magnitude” of an
6 accounting mistake can give rise to a cogent inference of deliberate misconduct).

7 The magnitude of the error, however, is not the only consideration. Courts must also
8 weigh the complexity or simplicity of the relevant accounting standard. *See Edward J.*
9 *Goodman Life Income Trust v. Jabil Circuit, Inc.*, 594 F.3d 783, 792 (11th Cir. 2010)
10 (holding that in conducting its analysis of scienter, a district courts’s scienter may consider
11 whether “the GAAP provision at issue [was or] was not a simple accounting policy”). Where
12 a provision at issue is subject to competing interpretations that are reasonable and when the
13 error is relatively small in magnitude, the inference of scienter is generally weak. *See In re*
14 *Taleo Corp. Sec. Litig.*, 2010 WL 597987, at *10 (N.D. Cal. Feb. 17, 2010). Conversely,
15 where GAAP provisions are relatively straightforward or basic and the mistake is pervasive
16 over a long period of time, the inference of scienter may be much stronger. *See, e.g., Backe*
17 *v. Novatel Wireless, Inc.*, 642 F. Supp.2d 1169, 1185–86 (S.D. Cal. 2009) (finding scienter
18 where defendants were alleged to have shipped products prematurely and, in doing so,
19 violated “basic” accounting principles). Similarly, when the relevant provision pertains to
20 an important company policy and as the nature of the accounting violation becomes more
21 obvious, the “inference of scienter becomes more probable[.]” *In re MicroStrategy, Inc. Sec.*
22 *Litig.*, 115 F. Supp.2d 620, 637–38 (E.D. Va. 2000). A plaintiff, however, cannot merely
23 point at a GAAP principle and contend that a correct interpretation was simple or obvious.
24 At the very least, the plaintiff must present facts demonstrating that the defendant was aware
25 of the relevant GAAP principle and that this defendant knew how that principal was being
26 interpreted. The plaintiff must then plead facts explaining how the defendant’s incorrect
27 interpretation was so unreasonable or obviously wrong that it should give rise to an inference
28

1 of deliberate wrongdoing. *See Medicis*, 689 F. Supp.2d at 1204 (citing *Zucco Partners*, 552
2 F.3d at 1000; *South Ferry*, 552 F.3d at 785).

3 This case presents the scenario where the accounting violation was not particularly
4 great in magnitude, but where the relevant violation was relatively straightforward or
5 obvious. As an initial matter, Plaintiffs' have cured any defect pertaining to whether
6 Defendants knew of relevant GAAP principal and were aware of Medicis's interpretation of
7 that provision. In the Second Amended Complaint, Plaintiffs allege that Medicis executives,
8 in particular Peterson and Prygocki, emphasized the importance of the Company's return
9 methodology and stated that the Company was not "booking revenue in advance of future
10 quarters." (Doc. 74 at ¶ 123). More significantly, Medicis's financial statements prior to the
11 Restatement, which were signed by Shacknai and Prygocki, specifically identify the
12 Company's reserve methodology as one of Medicis's most "critical accounting policies." (*Id.*
13 at ¶ 71). Thus, given the importance of reserves to Medicis's business, Plaintiffs have
14 adequately pled particular facts demonstrating that the executive Defendants were all well
15 aware of SFAS 48, which governs revenue recognition where a right of return exists, and the
16 Company's interpretation of that provision. Similarly, because Ernst & Young signed-off on
17 the financial statements as the Company's auditor, there is a strong inference that it too was
18 aware of Medicis's interpretation of SFAS 48. But, while Plaintiffs have alleged facts
19 demonstrating these Defendants' knowledge of the relevant accounting methodology, this
20 answers only half of the question. The next inquiry is whether Defendants' mistaken
21 interpretation of this "critical accounting policy" resulted in an accounting error of significant
22 magnitude or was so obvious that Defendants must have known of their mistake.

23 As set forth in the Court's previous Order, Defendants' alleged accounting violation
24 does not appear to have been so great in magnitude that Defendants must have known of the
25 mistake. *See Medicis*, 689 F. Supp.2d at 1206. Instead, Medicis's Restatement indicates that
26 the mistake had very little effect on cash, liquidity, or the viability of Medicis's core-business
27 operations. *Id.* Medicis initially overstated revenue because the Company deducted only the
28 replacement cost of pharmaceuticals, rather than the full sales price, in calculating its

1 reserves. In subsequent accounting periods, the inflated revenue was offset by the fact that
2 the Company did not actually expend the full sales price—since the cost of replacing the
3 expired items was actually less than the full price. *Id.* Thus, in the end, the accounting error’s
4 primary effect was to shift the amount of total revenue among different fiscal periods. *Id.*
5 This, without more, does not give rise to an inference of scienter.

6 But while the GAAP violation does not appear to have been very large in magnitude,
7 the relative simplicity and obviousness of the mistake presents a more difficult issue. On the
8 one hand, the terms of SFAS 48 do not explicitly address the accounting question at issue in
9 this case. Though SFAS 48 clearly requires a company to set reserves based on the full sales
10 price of the estimated number of returns when a company sells products with a general right
11 of return, it does not appear to specifically consider the scenario where a company sells
12 products without any right to return the product for a refund, but merely allows customers
13 to exchange an expired or short-dated product for a fresher unit of the product. (*See* Doc. 57,
14 Ex. D at ¶ 6). Given the lack of explicit guidance, Defendants’ accounting methodology,
15 which appears to have captured the economic impact of product exchanges, might have been
16 aggressive, but it was not necessarily unreasonable. *See Medicis*, 689 F. Supp.2d at 1206. On
17 the other hand, however, SFAS 48, and specifically Footnote 3 thereto, provides in a
18 relatively straightforward manner that exchanges should be treated as other returns unless the
19 exchanges are made “by ultimate customers of one item for another of the same kind, quality,
20 and price.” (Doc. 57 at 10 n. 3). The idea that expired and fresh pharmaceuticals are of the
21 same “quality” simply seems incorrect. Yet, that is the premise underlying Defendants’
22 alleged interpretation of SFAS 48. Additionally, the exception in Footnote 3 applies only
23 when a defendant is selling products to “ultimate customers.” *Id.* SFAS 48 quite clearly
24 distinguishes an “ultimate customer” from “a party who resells the product to others.” *Id.* at
25 ¶ 3. Given their apparent familiarity with SFAS 48, Defendants must have at least questioned
26 whether their wholesale distributors fell within the meaning of “ultimate customers.” *See id.*

27 These facts, as pled in the Second Amended Complaint, give rise to at least some
28 inference that Defendants’ interpretation of SFAS 48 was intentional or deliberately reckless.

1 While Defendants' methodology does appear to have taken into account the actual economic
2 costs of product exchanges, SFAS 48 is relatively straightforward and simple. Indeed, courts
3 that have addressed SFAS 48 in other contexts have noted its relative simplicity. *Greebel v.*
4 *FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999) (observing that “[v]iolations of GAAP
5 standards such as [S]FAS 48 could provide evidence of scienter” when described with
6 sufficient particularity); *Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir. 1994)
7 (noting that premature recognition of revenue in violation of SFAS 48 “run[s] afoul of Rule
8 10b-5”). Furthermore, the notion that an expired pharmaceutical could be considered to be
9 the same in “quality” as fresh product is untenable given that expired drugs cannot be sold
10 to consumers. It appears that Defendants must have appreciated this fact because they
11 allegedly established a special reserve inventory in Medicis’s warehouse for expired
12 pharmaceuticals. (Doc. 74 at 65). To be sure, Plaintiffs’ allegations also give rise to the
13 competing, and somewhat compelling, inference that the error may have been nothing more
14 than an aggressive interpretation that had only a minor effect on Medicis’s core business
15 operations. Nonetheless, given their familiarity with SFAS 48, Defendants must have at least
16 questioned whether their accounting methodology went too far. *See Jabil Circuit*, 594 F.3d
17 at 792 (noting that “a violation of GAAP by a corporation can raise an inference of scienter
18 when the defendants also ignored ‘red flags’ warning them of the accounting irregularities”).
19 Accordingly, the allegations pertaining to the simplicity and obviousness of SFAS 48 give
20 rise to at least some inference of intentional or deliberate misconduct. *See PR Diamonds*, 364
21 F.3d at 684. That inference, when viewed in conjunction with Plaintiffs’ other allegations,
22 creates a cogent inference of scienter.

B. Defendants' Alleged Failure to Disclose its Interpretation of SFAS 48 Gives Rise to an Inference of Scienter.

Several courts have also noted that an omission in public statements of material facts related to the GAAP violations can also give rise to a strong inference of scienter in certain circumstances. See *Malone*, 26 F.3d at 479; *Focus Enhancements*, 309 F. Supp. at 152 (quoting *Chalverus v. Pegasystems, Inc.*, 59 F. Supp.2d 226, 234 (D. Mass. 1999)). For

1 instance, in *Malone*, 26 F.3d at 479, a company made public statements regarding its revenue
2 without disclosing that the company had a generous return policy. In finding a strong
3 inference of scienter, the Fourth Circuit noted the company's violations of SFAS 48
4 combined with the omission of the return policy in the public statements were "more than
5 sufficient to support [an] inference that [the defendants] intended to deceive, manipulate, or
6 defraud investors." *Id.* Hence, when a Defendant knowingly adopts a questionable or tenuous
7 accounting methodology and fails to disclose material facts regarding that methodology to
8 investors, an inference of scienter may arise. *See id.* In contrast, where a defendant fully
9 discloses its accounting methodology in a "transparent manner," and the methodology is later
10 shown to violate GAAP, any inference of scienter will be substantially tempered. *See Taleo*
11 *Corp.*, 2010 WL 597987, at * 10; *see also In re WatchGaurd Sec. Litig.*, 2006 WL 2038656,
12 at *5–6 (W.D. Wash. Apr. 21, 2006) (finding that the plaintiffs' allegations failed to support
13 a strong inference of scienter where defendants had "consistently disclosed" the accounting
14 error on which a restatement was based because the "blatant error had been committed . . .
15 in open and notorious fashion for years").

16 Plaintiffs' Second Amended Complaint raises new allegations pertaining to
17 Defendants' failure to disclose material facts about their interpretation of SFAS 48.
18 Significantly, Medicis's public disclosures, which were issued with the advice of the
19 Company's auditor while the accounting violation was still on-going, do not state or imply
20 that Medicis was accounting for exchanges of expired drugs pursuant to an exception to
21 SFAS 48. Instead, the disclosure arguably implied that the Company was accounting for
22 exchanges in the same manner as products sold with a right of return:

23 [P]rograms are established as a reduction of product sales
24 revenues at the time such revenues are recognized. These
25 deductions from gross revenue are established by the
26 Company's management as its best estimate at the time of sale
27 based on historical experience adjusted to reflect known changes
28 in the factors that impact such reserves, including but not limited
to, prescription data, industry trends, competitive developments
and estimated inventory in the distribution channel.

29 ***

1 Provisions for estimates for product returns and exchanges, sales
2 discounts, chargebacks, managed care and Medicaid rebates and
3 consumer rebate and loyalty programs are established as a
reduction of product sales revenues at the time such revenues
are recognized.

4 (Doc. 74 at ¶ 51). Hence, while Medicis revealed that it reserved revenue for exchanges, it
5 did not reveal that it was setting reserves at replacement cost rather than the full sales price
6 of estimated exchanges. Meanwhile, Heska Corporation, the single other pharmaceutical
7 company that consistently accounted for exchanges in the same manner as Medicis, provided
8 in its public filings that it had “record[ed] an accrual for the estimated *cost of replacing* the
9 expired product expected to be returned in the future.” (Doc. 74 at ¶ 49 (emphasis added)).
10 Thus, while Medicis was silent about its methodology, a competitor that employed the same
11 interpretation of SFAS 48 transparently disclosed that its reserves were based on replacement
12 cost, rather than the full sales price, of anticipated exchanges.

13 As set forth in this Order, Defendants considered their reserve accounting
14 methodology to be a “critical” component of Medicis’s business. It is also fairly likely that
15 Defendants must have at least questioned the propriety of that methodology with respect to
16 exchanges for expired drugs. Yet, despite the fact that Defendants must have at least had
17 some doubt about their interpretation of SFAS 48, they chose to conceal their replacement
18 cost methodology from investors. This was in sharp contrast to the other major
19 pharmaceutical company that adopted a similar accounting approach. And while Defendants
20 argue that their disclosures were almost identical to those issued by several other
21 pharmaceutical companies, this argument ignores the fact that these other companies were
22 accounting for returns and exchanges in accordance with SFAS 48.

23 To be sure, there may well be legitimate reasons for Defendants’ failure to disclose
24 more facts pertaining to Medicis’s violation of GAAP. Nevertheless, the alleged omission
25 of relevant facts pertaining to the accounting methodology at issue gives rise to an inference
26 that Defendants intentionally concealed their tenuous interpretation of SFAS 48 from
27 analysts and investors.

28

1 **C. Plaintiffs Have Adequately Alleged that Defendants Were Exploiting the**
2 **Accounting Methodology to Control the Timing of Revenue Recognition.**

3 Another potential consideration in federal courts' scienter analysis is the alleged
4 motive or purpose underlying the defendants' accounting violation. *See Hypercom Corp.*,
5 2006 WL 726791, at *9 (observing that "[t]he presence of 'motive' . . . may contribute to a
6 strong inference of scienter") (citing *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp.2d
7 1248, 1269 (N.D. Cal. 2000)). For instance, when a defendant's violation of accounting
8 principles allows a company to obtain a financial benefit or a competitive advantage, courts
9 generally find at least some inference of scienter. *See Telabs*, 551 U.S. at 325 (holding that
10 "motive can be a relevant consideration" and that "personal financial gain may weigh heavily
11 in favor of a scienter inference"). To be clear, "motive and opportunity *alone* are insufficient
12 to show scienter at the pleading stage[;]" nonetheless, these factors may "still be considered
13 as circumstantial evidence" of the relevant state of mind. *See Howard v. Everex Sys.*, 228
14 F.3d 1057, 1064 (9th Cir. 2000) (citation omitted). Indeed, allegations of motive or
15 opportunity become more compelling when detailed facts are alleged demonstrating that the
16 defendant actually exploited the accounting violation over a long-period of time to achieve
17 an improper purpose. As the Southern District of New York recently observed in *In re IMAX*
18 *Sec. Litig.*, 587 F. Supp.2d 471, 483 (S.D. N.Y. 2008), a plaintiff may sufficiently allege
19 scienter when sets forth facts demonstrating that a defendant "underst[ood] . . . the relevant
20 accounting rules," appreciated "the ramifications of selecting certain interpretations of the
21 rules over others," and adopted an "increasingly aggressive accounting of [product] revenue."

22 Although the facts demonstrating Defendants' alleged motive are not overly
23 compelling, they do at least create an inference that Medicis was using its accounting
24 methodology to create an appearance of sustained Company growth. According to Plaintiffs,
25 Medicis "touted itself as a pharmaceutical company of consistent and reliable growth—which
26 could be counted on to continuously break previously set revenue records." (Doc. 74 at ¶
27 148). This image was allegedly maintained by exploiting their flawed interpretation of SFAS
28 48 to push forward revenues in certain quarters to maintain the illusion of consistent and

1 steady growth. For example, from 2002 to 2003, the Company reported that its revenues
2 increased from \$212 million to \$247.52 million, an increase of 16.3%. *Id.* at ¶ 149. In reality,
3 the Company's actual revenues for 2003 were \$210.3 million, which represented a decline
4 from the prior year's revenues of \$212.8 million. *Id.* Similarly, in November 2007, the
5 Company announced revenues of \$120.4 million, compared to the prior quarter's revenue of
6 \$108 million. *Id.* at ¶ 148. In reference to these financial results, Shacknai, boasted of
7 "another record revenue quarter" for Medicis. However, the Company's restated figures
8 demonstrate that Medicis's actual revenue for that period was only \$110.9 million,
9 approximately \$3 million less than the Company's restated revenues of \$113 million for the
10 prior quarter. *Id.*

11 These changes in Medicis's financial statements, while not particularly substantial,
12 do contribute to the inference of scienter. Here, Medicis allegedly exploited its accounting
13 methodology to recognize revenues well in advance of when it should have, and allegedly
14 did so to craft an image of constant growth and expansion. Indeed, if revenue appeared to be
15 somewhat low toward the end of a particular year or quarter, Medicis allegedly used its
16 flawed accounting methodology to send large quantities of short-dated pharmaceutical
17 products to its wholesale distributors, booked revenues on those sales despite knowledge that
18 many of the short-dated products would be returned, and then failed to adequately reserve
19 the full sales value of anticipated returns. Given that some of the products would not be
20 returned or exchanged for years from the time that revenue was recognized, it appears that
21 these are precisely the types of specious accounting activities that GAAP and SFAS 48 are
22 intended to prevent. (*See Doc. 57, Ex. D at ¶ 15*) ("Situations that pose particular problems
23 occur when sales result in significant overstocking by customers acquiring product for resale.
24 In those situations, the recognition of revenue in one period is followed by substantial returns
25 in a later period."). Indeed, much like the defendants in *IMAX*, 587 F. Supp.2d at 483, it
26 appears that Medicis and its auditor understood the relevant accounting provision,
27 appreciated the "ramifications of selecting [a] certain interpretation . . .," and then employed
28 an "increasingly aggressive accounting of [product] revenue."

1 These allegations also have some applicability to Ernst & Young. Although the
2 auditing firm likely did not share Medicis's motive or purpose, given the prominence of the
3 accounting provision to Medicis, Ernst & Young would have known how the Company's
4 accounting interpretation might have been exploited. Yet, Ernst & Young allegedly did
5 nothing to prevent Medicis from employing a tenuous accounting method to manipulate
6 revenues. That Medicis employed an accounting methodology that allowed the Company to
7 easily manipulate the timing of revenues should have at least raised red flags regarding the
8 propriety of Medicis's accounting treatment. *See Jabil Circuit*, 594 F.3d at 792 ("[A]
9 violation of GAAP by a corporation can raise an inference of scienter when the defendants
10 also ignored 'red flags' warning them of the accounting irregularities."). And while this
11 alleged purpose standing alone does not create a cogent inference of scienter, when it is
12 considered along with the other allegations in the Second Amended Complaint, it does
13 contribute to the overall inference that Defendants may have acted deliberately.

14 **D. Plaintiffs' Allegations, When Considered Holistically, Give Rise to a
15 Sufficient Inference of Scienter Under § 10(b).**

16 Plaintiffs' Second Amended Complaint, when considered holistically, gives rise to a
17 sufficient inference that Defendants acted knowingly or with deliberate recklessness in
18 setting its reserves. When considering allegations of scienter, courts must "determine whether
19 the complaint," as a whole, "contains an inference of scienter that is greater than the sum of
20 its parts." *Rubke v. Cap. Bancorp Ltd.*, 551 F.3d 1156, 1165 (2009). Under this "holistic"
21 approach, "federal courts . . . need not close their eyes to circumstances that are probative of
22 scienter [when] viewed [from] a practical and common-sense perspective." *South Ferry*, 542
23 F.3d at 784.

24 As set forth in this Order, Plaintiffs' allegations give rise to a cogent inference of
25 scienter for three reasons: (1) Defendants misapplied SFAS 48, even though that provision
26 is relatively simple and straightforward; (2) even though Defendants must have been aware
27 that its interpretation was somewhat tenuous, Defendants failed to disclose their accounting
28 methodology to investors; and (3) Defendants allegedly exploited their accounting

1 methodology to manipulate revenue recognition and create an image of constant growth.
2 Though Plaintiffs' allegations may not be sufficient to give rise to the requisite state of mind
3 if considered in isolation, they do give rise to a cogent inference of scienter when considered
4 collectively.

5 **II. Plaintiffs Have Adequately Alleged § 20(b) Liability.**

6 Section 20(a) of the Exchange Act provides for joint and several liability of persons
7 who control primary violators of the securities laws:

8 Every person who, directly or indirectly, controls any person
9 liable under any provision of this chapter or of any rule or
10 regulation thereunder shall also be liable jointly and severally
11 with and to the same extent as such controlled person to any
12 person to whom such controlled person is liable, unless the
13 controlling person acted in good faith and did not directly or
14 indirectly induce the act or acts constituting the violation or
15 cause of action.

16 *Id.* As the Ninth Circuit has further explained, "In order to prove a *prima facie* case under
17 Section 20(a), a plaintiff must prove: (1) 'a primary violation of federal securities law' and
18 (2) 'that the defendant exercised actual power or control over the primary violator.'" *No. 84*
19 *Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d
20 920, 945 (9th Cir. 2003) (quoting *Howard*, 228 F.3d at 1065). After a plaintiff sets forth a
21 *prima facie* case, the burden shifts to the defendant to show that it acted in good faith—i.e.
22 that it lacked scienter or did not directly or indirectly induce the misconduct. *Id.*

23 In the instant case, Plaintiffs have adequately pled a § 20(b) claim against Shacknai,
24 Peterson, and Prygocki. The first element is satisfied because, as discussed above, the Second
25 Amended Complaint has adequately alleged a primary violation of § 10(b) against Medicis
26 and its executive officers. The second element is also satisfied because Shacknai, Peterson,
27 and Prygocki are alleged to have had the power and ability to control the actions of Medicis
28 and its employees.

29 **CONCLUSION**

30 As set forth in this Order, Plaintiffs's Second Amended Complaint cures the defects
31 identified by the Court in its previous Order.

IT IS THEREFORE ORDERED that Defendants' Motions to Dismiss (Doc. 80, 81) are **DENIED**.

DATED this 9th day of August, 2010.

G. Murray Snow
G. Murray Snow
United States District Judge